Supreme Court of Kentucky

Case No. 2013-SC-000122-D

COURT OF APPEALS CASE NO. 2011-CA-000121-MR
KENTON CIRCUIT COURT NO. 08-CI-02787

COPPAGE CONSTRUCTION COMPANY, INC. — **APPELLANT**

v.

SANITATION DISTRICT NO. 1 AND
DCI PROPERTIES-DKY, LLC — **APPELLEES**

BRIEF FOR APPELLANT
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CERTIFICATE OF SERVICE

It is hereby certified that a copy of the foregoing was mailed this 9th day of June, 2014, to J. Stephen Smith, Michael S. Surrey, Lynda H. Mathews, Graydon Head & Ritchey, LLP, 2400 Chamber Center Drive, Suite 300, Fort Mitchell, KY 41017; Jeffrey C. Mando, Jennifer H. Langen, Adams, Stepner, Woltermann & Dusing, PLLC, 40 W. Pike Street, Covington, KY 41012-0861, *Counsel for Appellee-Sanitation District No. 1;* Robert B. Craig, Taft Stettinius & Hollister LLP, 1717 Dixie Hwy, Suite 340, Covington, KY 41011-4704; Chad R. Ziepfel, Taft Stettinius & Hollister, LLP, 425 Walnut Street, Suite 1800, Cincinnati, OH 45202-3957, *Counsel for Appellee-DCI Properties-DKY-LLC;* Clerk, Kentucky Court of Appeals, 360 Democrat Drive, Frankfort, KY 40601; and to the Kenton Circuit Court Clerk, Justice Center, 230 Madison Avenue, Covington KY 41011.

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INTRODUCTION

The Court of Appeals erred in holding that Sanitation District No. 1 of Northern Kentucky ("SD1"), a sanitary sewer utility organized under KRS Chapter 220, is entitled to sovereign immunity to the same extent as the Commonwealth itself or a county government. SD1 is not an agency or arm of state or county government, nor does it perform a function integral to state government; it is a municipal corporation established by voluntary petition, which provides proprietary sanitary sewer utility services to customers in a local area for a fee, just like any public utility.

STATEMENT OF POINTS AND AUTHORITIES

STATEMENT OF THE CASE

This appeal arises from the Kenton Circuit Court's summary judgment order dismissing all of Appellant Coppage Construction Company, Inc.'s ("Coppage") contract, tort, and statutory claims against SD1 on the basis of sovereign immunity. Coppage's claims arise from SD1's improper management and direction and breach of its contractual obligations related to a major project to expand and improve SD1's pre-existing sewer lines in the vicinity of the City of Dayton, Kentucky (the "Sewer Line Project" or the "Project"). The Kenton Circuit Court did not address the merits of Coppage's underlying claims. Instead, it held that under the framework set forth in *Comair, Inc. v. Lexington-Fayette Urban County Airport Corp.*, 295 S.W.3d 91, 99 (Ky. 2009), SD1 was an agent or alter ego of the county governments located in the territories served by SD1, and was therefore clothed in sovereign immunity to the same extent as a county government or the Commonwealth of Kentucky itself.

The Court of Appeals affirmed in a "to be published" decision, which grievously misconstrues the criteria for sovereign immunity set forth in *Comair* and threatens to massively expand the scope of sovereign immunity. The logic of the Court of Appeals decision would, if affirmed, justify extending sovereign immunity to thousands of "special districts" in Kentucky and other types of municipal corporations that are not arms or agents of the Commonwealth or any county in any meaningful sense, and which provide proprietary utility services to address local, not statewide, concerns.

Sanitation District No. 1 of Northern Kentucky and Kentucky "Special Districts"

SD1 is a public sewer utility servicing communities in Northern Kentucky. According to its website, "SD1 is the second largest public sewer utility in Kentucky,

with ownership and maintenance responsibilities for all of the sanitary sewer systems in Northern Kentucky, with the exception of Florence and Walton. SD1 maintains more than 1,600 miles of sanitary sewer line, 142 wastewater pumping stations, 15 flood pump stations, 8 package treatment plants, three major wastewater treatment plants, more than 400 miles of storm sewer, and over 29,000 storm sewer structures."[1] The largest public sewer utility in Kentucky is Louisville Metro's Metropolitan Sewer District ("MSD"), which operates 3,200 miles of sewer lines, 270 sanitary sewer pumping stations, 16 flood pumping stations, and a 376-square mile stormwater drainage system.[2]

Like any public utility, SD1's operations are financed primarily through fees for utility services charged to customers.[3] Approximately 84% of SD1's FY2010 revenue was derived from sanitary sewer rates and fees.[4]

SD1 is organized as a sanitation district under the provisions of KRS Chapter 220. Under KRS Chapter 220, a sanitation district can be created only by petition of affected landowners or the incorporated municipalities in the area to be served. KRS 220.040.[5] Accordingly, SD1 was originally "created ... by petition of about seventeen incorporated areas and communities located in northern Kentucky." *City of Covington v. Sanitation Dist. No. 1 of Campbell & Kenton Counties*, 301 S.W.2d 885, 886 (Ky. 1957). SD1 originally came about as a result of several incorporated municipalities' efforts to pool their sewage facilities to achieve economies of scale:

Several of the larger cities, such as Newport and Covington, had existing

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[1] http://www.sd1.org/AboutSD1/SD1_History.aspx (last visited February 13, 2013). *See also* SD1 COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR FY ENDED JUNE 30, 2013 ("SD1 ANNUAL REPORT") at pp. 1-2 (available at http://www.sd1.org/Resources.aspx?cid=8).

[2] MSD Info. Brochure at pp. 3-5, http://www.msdlouky.org/aboutmsd/pdfs/MSD_gen_brochure_web.pdf.

[3] *See* August 17, 2011 SD1 Audit Report at pp. 8, 19 (available at http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2011SanitationDistrict1examination.pdf.).

[4] *Id.* at 19.

[5] The same requirement existed when SD1 was first formed. 1940 Ky. Acts, Ch. 148, §4.

> sewer facilities and, in all, there were about 33,000 property owners who had connections with them. The big problem, however, was the collection and disposal of sewage. Separate undertakings to accomplish this end would have required a tremendous outlay of money and, therefore, as a community project, the several cities undertook, by the creation of this district, to accomplish, by joint action at a lesser expense, the task of sewage disposal by modern methods.

Id.

KRS Chapter 220 provides for a sanitation district to be organized and operated as a municipal corporation. KRS 220.110, *et seq. Accord Louisville/Jefferson County Metro Ethics Com'n v. Schardein*, 259 S.W.3d 510, 512 (Ky. App. 2008) (sanitation district is a "municipal corporation[] of the Commonwealth of Kentucky ..."). They are managed by a board of directors and governed by articles of incorporation. KRS 220.110 - .170. Upon formation, a sanitation district is a body corporate with, among other things, the "power to sue and be sued, contract and be contracted with, incur liabilities and obligations.... " KRS 221.110(1). Sanitation districts are also statutorily authorized to issue bonds to finance their activities "us[ing] the authority and procedures granted to incorporated municipalities by KRS 107.010 to 107.220 ...." KRS 220.380(2).

Sanitation districts are one of many types of "special districts" that exist in Kentucky. "Special districts" are a common, but less well known, form of municipal corporation. A recent report by the Auditor of Public Accounts estimated there are more than 1200 special districts, and more than 50 different types of special districts, operating in Kentucky.[6] The term "special districts" refers to political subdivisions "other than counties or cities" that "are created to perform a limited number of services within a

[6] ADAM H. EDELEN, AUDITOR OF PUBLIC ACCOUNTS, GHOST GOVERNMENT: A REPORT ON SPECIAL DISTRICTS IN KENTUCKY (hereinafter "GHOST GOVERNMENT"), Nov. 14, 2012, at p. 5 (available at http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2012GhostGvoernmentSpecialDistrictsreport.pdf)

limited geographical area."[7] While "special districts" are typically subject to some oversight by the county governments for the territories they serve, "county government has little authority to regulate the day-to-day operation of most special districts."[8]

The independence of "special districts" is by design. A principal reason for the creation of "special districts" is to avoid constraints imposed by state constitutional or statutory limits on counties' debt or taxing authority. *See, e.g., Lowery v. Jefferson County*, 458 S.W.2d 168, 173 (Ky. 1970). "Special districts with taxing or bonding power have been a way to get around such limits, because they are independent of county government and their taxes and bonded indebtedness do not count as part of the county limit."[9] This purpose requires that county government oversight of special districts be strictly limited, since "there are limits to the amount of control that county government could exercise without conflicting with the independent legal status of special districts."[10]

SD1 follows this pattern. As is the case with most "special districts," county judge executives and fiscal courts have certain powers to appoint board members and to review and approve budgets and certain major projects, but day-to-day management responsibility and responsibility for carrying out projects and district plans is entrusted solely in the board of directors. *E.g.*, KRS 220.140, .160, .170, .220, .280. *See also Sanitation Dist. No. 1 of Shelby County v. Shelby County*, 964 S.W.2d 434, 437 (Ky. App. 1998) (because the district, not the county government "exercises sole authority in

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[7] LEGISLATIVE RESEARCH COMMISSION ("LRC"), COUNTY GOVERNMENT IN KENTUCKY at 127 (2003) (available at http://www.lrc.ky.gov/lrcpubs/ib%20115.pdf) (emphasis added). *See also* KRS 65.005(2)(b).
[8] LRC, COUNTY GOVERNMENT IN KENTUCKY, *supra* note 7, at 128.
[9] LRC, COUNTY GOVERNMENT IN KENTUCKY, *supra* note 7, at 127. *See also* LARITA KILLIAN & DAGNEY FALK, POLICY BRIEF: SPECIAL DISTRICTS & LOCAL GOVERNMENT REFORM at p. 2 (Ball State Univ. Ctr. for Business & Economic Research, March 2012) (available at http://cms.bsu.edu/-/media/WWW/DepartmentalContent/MillerCollegeofBusiness/BBR/Publications/SpecialDistricts2012.pdf) ("Often, special districts are formed to circumvent debt limits imposed on general local governments by states.").
[10] LRC, COUNTY GOVERNMENT IN KENTUCKY, *supra* note 7, at 128.

carrying ... out" approved projects, there was "no question" that county officials were improperly engaged in "dual management" of multiple municipal entities).

The SD1 Sewer Line Project and Background to the Dispute

The Sewer Line Project from which the present dispute arose was undertaken in connection with a private mixed-use development project in Dayton, Kentucky, known as the Manhattan Harbour project. In 2005, DCI-Properties-DKY ("DCI"), a private development company, entered into a development agreement with the City of Dayton to build the Manhattan Harbour project along the Ohio River. Construction of the Manhattan Harbour project necessitated relocation of SD1's existing sewer line in that area. DCI originally proposed to replace the existing line with one of the same size and capacity, but SD1 saw the project as an opportunity to significantly expand and improve its sewer line to address obligations SD1 undertook as part of a Consent Decree it had entered resolving violations of state and federal environmental laws.[11]

Accordingly, SD1 initiated negotiations with DCI to modify the relocation plan to include replacing SD1's existing sewer line with a vastly expanded 84 inch diameter line spanning over 8000 linear feet, which SD1 would own upon completion. This multi-million dollar contract was never advertised for public bidding. Nor was DCI required to furnish any payment or performance bond, despite SD1's standard policy to require payment and performance bonds and KRS 220.290's requirement that contractors "give bond with ample surety for the faithful performance of the contract."[12]

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[11] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl., ¶14. The Consent Decree required SD1 to make "extensive improvements to its sewer systems to eliminate unauthorized overflows of raw sewage and to control overflows of combined sewage and stormwater." *Id.*

[12] *Id.* ¶¶ 16-20. Article 5, ¶ 5.01A of SD1's Standard Specifications and Details states "CONTRACTOR shall furnish performance and payment Bonds, each in an amount at least equal to the Contract Price as security for the faithful performance of all CONTRACTOR's obligations under the Contract Documents."

DCI is a development company with a single employee and no experience in sewer construction.[13] Thus, before entering into any contract for the Sewer Line Project, SD1 and DCI requested a price proposal from Coppage, which had extensive experience in sewer system construction.[14]

After Coppage provided its proposal, SD1 entered into an agreement with DCI (the "SD1 Contract") for the design and construction of the Sewer Line Project. SD1 agreed to pay $10,550,000.00 (later increased to more than $14 million) of the Project's then-estimated $14,651,356 total cost.[15] The SD1 Contract identifies Coppage as the party to perform the work on the Project, and expressly incorporates Coppage's proposal.[16] Upon execution, SD1's Director of Capital Improvements sent an email to Coppage stating "we are good to go."[17] DCI then entered into a contract with Coppage (the "Coppage Contract") for Coppage to provide labor, materials, and equipment.

SD1 exercised considerable control over the Project, and Coppage's work in particular. The SD1 Contract gave SD1 authority to inspect and approve the construction and specifications, and SD1 made clear to Coppage that work could not be performed until SD1 gave approval. SD1 regularly inspected Coppage's work and at times issued directions directly to Coppage on aspects of its work.[18] SD1 reviewed Coppage's applications for payment and decided how much of the billed amounts it would pay DCI

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[13] R. 1652-1705, DCI Answer, at ¶ 6, *SD 1 of N. Ky. v. DCI, et al*, Case No. 10-CI-379 (Campbell Circuit Court) (attached as Ex. B to Coppage Mem. in Opp. to DCI Mot. For Leave to File Resp. (Sep. 23, 2010)).
[14] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl., ¶ 14; R.1652-1705, DCI Answer, at ¶ 7, *SD 1 of N. Ky. v. DCI, et al*, Case No. 10-CI-379 (Campbell Circuit Court) (attached as Ex. B to Coppage Mem. in Opp. to DCI Mot. For Leave to File Resp. (Sep. 23, 2010).
[15] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl., ¶ 21.
[16] *Id.* ¶¶ 22-23 & Exhibit A.
[17] *Id.* ¶ 23.
[18] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl., ¶¶ 24-41.

for Coppage's work.[19] SD1 and Coppage also reviewed the monthly progress of Coppage's work to verify how much should be billed and paid for Coppage's work in that period.[20]

From the very beginning, however, Coppage encountered significant difficulties with nonperformance by both SD1 and DCI, including nonpayment for work and materials, and unwarranted and costly delays caused by DCI's and SD1's actions. For example, under the SD1 Contract, SD1 was to transfer to DCI an initial payment for the anticipated cost of the 84 inch pipe to pay to Coppage.[21] Coppage ordered 8000 feet of the 84 inch pipe for $2,456,000 from Hobas Pipe USA (the "Hobas Pipe"). SD1 approved the manufacturer, and knew the pipe was a custom-designed product that needed to be ordered in advance.[22] When Coppage sought reimbursement, however, DCI refused to pay anything until the pipe was installed.

Nevertheless, through most of 2007, Coppage made great progress on the Project, installing more than half of the line. Beginning in early 2008, however, Coppage's work was impacted and suspended for several months due to delays caused by DCI and SD1, including disputes between SD1 and DCI over engineering issues, the scope of the Project, and payments owed to the Project's geotechnical engineer.[23] For example, shortly after commencement, engineers detected soil settlement well in excess of what was predicted, causing SD1 to require design changes, resulting in delay and increased cost.[24] These issues forced Coppage to delay its schedules for materials delivery and

[19] *Id.* ¶ 58.
[20] *Id.* ¶ 61.
[21] *Id.* ¶ 30.
[22] *Id.* ¶ 50.
[23] *Id.* ¶¶ 68-87.
[24] *Id.* ¶¶ 73-81.

construction efforts. Coppage repeatedly notified DCI and SD1 that its work was being delayed by these issues.[25]

When the problems persisted, Coppage formally notified SD1 and DCI that its contract had been breached, and provided an opportunity to cure. Rather than cure, DCI terminated the Coppage Contract under a termination-for-convenience clause.[26] DCI did so only after obtaining assurance from SD1 that "the additional amount that SD1 is willing to pay on this project … will still be honored by SD1, even if we bring in another contractor."[27] Coppage continues to be owed millions, including substantial amounts for work performed and materials purchased and delivered to the Project.

The Kenton Circuit Litigation and Related Litigation Concerning the Project

After DCI terminated the Coppage Contract, DCI filed this suit against Coppage in Kenton Circuit Court, alleging that Coppage breached the Coppage Contract and seeking a declaratory judgment and damages (the "Kenton Circuit Litigation"). Coppage denied any breach, and counterclaimed against DCI.

Shortly after the Kenton Circuit Court Litigation was initiated, Coppage served Open Records Act requests on SD1 seeking documents related to the Project, SD1's policies concerning payment and performance bonds, and copies of contracts where payment and performance bonds were required. After SD1 failed to provide complete responses to these requests, Coppage filed suit. The court in that action found that SD1 violated the Open Records Act in numerous respects,[28] noting among other things that SD1's records retention policies "demonstrate[d] either a complete ignorance of

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[25] *Id.* ¶¶ 89-98.
[26] *Id.* ¶¶ 97-98.
[27] R. 1178-1220, Aug. 29, 2008 J. Parsons E-Mail (Ex. 6, Coppage Mem. in Opp. to SD1 Mot. to Dismiss).
[28] R. 1488-1526, Aug. 2, 2010 Order at 30-36, *Coppage Constr. Co. v. SD1*, Case No. 09-CI-00628 (Kenton Cir. Ct.) (Ex. 1 to Coppage Aug. 12, 2010, Notice of Supp. Submission).

applicable rules governing its records retention, or a deliberate attempt to mislead this Court with regard to those rules. Either scenario reflects badly on SD1."[29] The court also noted its "reflexive suspicion [of SD1] when this Court learned through its review of the pleadings that the construction contract at the heart of this dispute was a 10.5 million dollar contract entered into without competitive bidding."[30]

As the Kenton Circuit Court action continued to progress, SD1's other legal problems related to the Project continued to mount. In October 2009, the Kentucky Labor Cabinet issued a Notice of Violation against SD1 for failing to pay workers prevailing wages on the Sewer Line Project.[31] As it has in this action, SD1 attempted to disclaim responsibility for the Project, arguing initially it was solely the private project of DCI "that SD1 had no involvement in,"[32] but the Cabinet rejected this argument.[33]

SD1 similarly attempted to disclaim responsibility for the Project, and again failed, in another related action to contest a statutory lien filed by Coppage on SD1's funds in the Campbell Circuit Court.[34] The court in the lien action explained, "once SD1 became involved to the degree that they requested that the pipe be upgraded … the nature of the sewer line project changed."[35] The court found it "incongruous" that SD1 would argue it did not "own" a project for which it paid over $10 million.[36]

The SD1 Audit and State Auditor Inquiry into Special District "Ghost Governments"

The apparent irregularities in SD1's operations exposed by litigation over the Sewer Line Project, among other things, ultimately prompted the Kenton County Judge-

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[29] *Id.* at 26.
[30] *Id.* at 10-11.
[31] R. 1652-1705, D. Shattuck Aff. ¶2, Exhibit 7 to Coppage Mem. in Opp. to SD1 Mot. To Dismiss.
[32] *Id.*
[33] *Id.*
[34] *See* Jan. 4, 2010 Order, *Coppage v. SD1*, Civ. No. 08-CI-01745 (App. C to Coppage Ct. App. Br.).
[35] *Id.* at 6-7.
[36] *Id.*

Executive to request that the Kentucky Auditor of Public Accounts conduct an audit of SD1 in January 2011.[37] The audit request specifically noted concern over the bidding procedures in the Manhattan Harbour development, the Labor Cabinet's prevailing wage citation, and SD1's document retention practices, as well as issues raised in a suit by the former SD1 Controller, who claimed to have been "pushed out" after objecting to inappropriate financial adjustments and accounting practices.[38]

The Audit Report, issued August 17, 2011, found myriad problems with SD1's management, accounting, and ethics practices.[39] The SD1 Audit Report, among other things, found that "governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight," noted a "lack of strong, enforceable ethics policies," identified "several instances of accounting errors and lax accounting controls," and determined that "SD1 did not comply with its procurement guidelines when obtaining goods and services."[40]

The results of the SD1 audit, as well as other similar examinations into various special districts in Kentucky, subsequently prompted the Auditor of Public Accounts to launch a broader inquiry into "special districts" throughout Kentucky.[41] The Auditor's resulting report, entitled "Ghost Government," noted a "scandalous lack of system-wide

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[37] Mike Rutledge, *State to Audit SD1,* CINCINNATI ENQUIRER, Feb. 19, 2011.
[38] *Id.*
[39] CRIT LUALLEN, AUDITOR OF PUBLIC ACCOUNTS, EXAMINATION OF CERTAIN POLICIES, PROCEDURES, CONTROLS AND FINANCIAL ACTIVITY OF SANITATION DISTRICT 1 ("SD1 AUDIT REPORT"), Aug. 17, 2011 (http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2011SanitationDistrict1examination.pdf). *See also* Jim Hannah, *Auditor: SD1 Has Violated Own Rules, Has Lax Accounting Controls, Cincinnati.com,* August 17, 2011 (http://www.cincinnati.com/article/AB/20110817/NEWS0103/308170056/) ("State Auditor Crit Luallen's examination of Sanitation District No. 1's books found the public utility has violated its own competitive bidding rules, had apparent conflicts of interest with board members and has lax accounting controls.").
[40] SD1 AUDIT REPORT, *supra* note 39, at iii – vi.
[41] *Auditor Edelen Announces Major Initiative to Shine Light on Special* Districts, June 6, 2012, http://www.adamedelen.com/2012/06/06/auditor-edelen-announces-major-initiative-to-shine-light-on-special-districts/.

oversight" of special districts in Kentucky and observed that "[s]pecial districts are a multi-billion dollar layer of government ... that operate outside any uniform system of accountability."[42] The report found that, unlike city and county governments, "[s]pecial districts do not currently have a universal requirement to conform to a code of ethics."[43] The report noted that "state laws that require special districts to comply with financial and organizational reporting requirements are a patchwork of provisions that include a great deal of overlap, and some glaring omissions."[44] The predictable consequence it found was widespread failure by special districts to comply with the limited oversight requirements that are in place. For example, the report concluded that approximately 40% of special districts that are required to submit budgets for fiscal court approval do not do so, and roughly 45% of districts with annual revenues or expenditures of more than $750,000 failed to comply with statutory requirements to perform annual audits.[45]

Based on the results of the "Ghost Governments" report, the State Auditor championed legislation designed to increase transparency of special governments, including the creation of a comprehensive database of special district information and measures designed to improve compliance with reporting and audit requirements.[46] However, consistent with the constitutional independence of special districts, the new legislation did not give fiscal courts broad new approval or veto powers over special districts. To the contrary, the Auditor fervently and successfully opposed amendments that would have given fiscal courts veto or approval rights over special district tax and rate decisions on the grounds that such direct county control would require special district

[42] GHOST GOVERNMENT, *supra* note 6, at 2.
[43] *Id.* at 3.
[44] *Id.* at 8.
[45] *Id.*
[46] KRS 65A.010 *et seq.*

debt to be included within the county limit, impairing counties' debt and bonding ability.[47]

Coppage's claims against SD1 and the Decisions on Appeal

The present appeal arises from the dismissal of Coppage's claims against SD1 in the Kenton County Litigation. In March 2010, Coppage sought – and was ultimately granted – leave to file a Third-Party Complaint asserting claims directly against SD1 in the Kenton Circuit Litigation. Coppage's Third Party Complaint asserts a variety of contract, statutory, and tort claims against SD1.[48] Coppage's Third-Party Complaint alleges, among other things, that SD1 is liable under the Coppage Contract pursuant to its joint venture and/or partnership by estoppel with DCI, and because SD1 so assumed control of the Project that it effected a novation. Coppage's Third-Party Complaint also asserts third-party beneficiary claims under the SD1 Contract, and claims for statutory violations and negligence in the management of the Project and interference with Coppage's work.

SD1 moved to dismiss, alleging that it was entitled to sovereign immunity. The Kenton Circuit Court treated SD1's motion as one for summary judgment and granted the motion, dismissing all claims against SD1 on the grounds that SD1 was entitled to sovereign immunity.[49] The Circuit Court acknowledged that this Court, in *Calvert Investments, Inc. v. Louisville & Jefferson County Metropolitan Sewer District*, 805 S.W.2d 133, 134-36 (Ky. 1991), had previously held that sanitary sewer districts are not

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[47] *Sarah Hogsed, State Auditor Voices Opposition to Amending Taxing District Oversight Bill*, RICHMOND REGISTER, 2013 WLNR 4451157, Feb. 20, 2013; *Jack Brammer, Lawmakers Pass Bill to Shed Light on Kentucky's Special Taxing Districts*, LEXINGTON HERALD-LEADER, 2013 WLNR 6156643, March 12, 2013.

[48] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl.

[49] R. 1820, 12/17/10 Order, attached as App. C.

entitled to sovereign immunity, but concluded that "in light of the *Comair* decision, the Court believes that the outcome of the *Calvert* case would be different if decided today."[50] Coppage appealed this decision.

On January 25, 2013, the Court of Appeals issued a "to be published" Opinion affirming the Circuit Court. The Opinion initially concluded that SD1 is an "arm" of the county governments for the territories it serves (Campbell, Kenton, and Boone) based solely on the conclusory statement that SD1 "was established by the County Fiscal Courts in accordance with KRS Chapter 220 and is controlled by the above counties and by the above counties in the state."[51] The Opinion did not cite, much less analyze, the particular statutory provisions in KRS Chapter 220 concerning the formation and governance of sanitation districts, including the fact that sanitation districts are created by petition of landowners or incorporated municipalities.

On the issue of whether sanitation districts perform a function integral to state government, the Court acknowledged *Calvert's* holding that the "Louisville and Jefferson County Metropolitan Sewer District ... did not perform a function integral to state government," but concluded that *Calvert* was "distinguishable and lacks precedential value."[52] The Opinion emphasized that the sewer district in *Calvert* was established under KRS Chapter 76, pertaining to "City-County Metropolitan Sewer Districts," whereas SD1 was created pursuant to KRS Chapter 220. However, the Opinion failed to identify any concrete differences in the actual functions performed by Chapter 76 and Chapter 220 sanitary sewer districts.

The Opinion further held that SD1's immunity barred Coppage's contract claims,

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[50] *Id.*
[51] App. B, Opinion at 7.
[52] *Id.*

as well as its tort claims, because the contract claims did not fall within the scope of the state's statutory waiver of immunity for written contract claims in KRS 45A.245(1).[53]

This Court granted Coppage's motion for review.[54] For the reasons stated below, this Court should now reverse the Court of Appeals and hold that SD1 is an ordinary municipal corporation that provides proprietary utility services in a local service area, and therefore is not entitled to sovereign immunity.

ARGUMENT

The Court of Appeals decision represents a radical departure from this Court's precedents concerning the scope of sovereign immunity, and threatens to exponentially expand the number of entities in Kentucky that can escape the civil consequences for wrongs they commit against Kentucky citizens. This Court's recent decision in *Comair* explained that sovereign immunity extends only to entities that are themselves an agency or "offspring" of an immune entity and that perform a "function integral to state government," rather than a local proprietary one. SD1 satisfies neither aspect of this test.

To the contrary, this Court has squarely held that sanitary sewer districts "carry out a limited public purpose in a local area" and "perform[] services similar to a private corporation," and therefore do not "carry[] out a function integral to state government" as required to "qualify for sovereign immunity." *Calvert*, 805 S.W.2d at 134-36, 138. Similarly, this Court emphasized in *Comair* that a key feature distinguishing non-immune "municipal corporations" from sovereign county entities is that municipal corporations are "called into existence .... by the free consent of the persons composing them," whereas immune county entities are created by the "sovereign will of the state" without

[53] *Id.* at 11 (citing *Commonwealth v. Whitworth*, 74 S.W.3d 695, 699 (Ky. 2002)).
[54] Attached as App. A.

the "solicitation" or "consent" of the persons who inhabit them. *Comair*, 295 S.W.3d at 100 (quotation omitted).

SD1 is a sanitary sewer district, which performs the same functions this Court held to be "local" and "proprietary" in *Calvert*. It provides utility services for fees charged to customers, just like any public or private utility corporation. Moreover, SD1 is organized as a municipal corporation, and by statute can only be established upon the petition and consent of the landowners occupying the district or the municipalities to be served. It was not – and cannot be – created by an act of "sovereign will" without the "solicitation" or "consent" of the people to be served. Affirming the Court of Appeals' decision would justify extending sovereign immunity to ***all*** of the thousand-plus special services districts operating in Kentucky, significantly compounding the already daunting problems presented by these entities' lack of accountability and representing an unprecedented and unwarranted expansion of sovereign immunity in Kentucky. Such a result would be bad policy, and would run contrary to decades of Kentucky jurisprudence emphasizing the need to restrict – rather than expand – the scope of sovereign immunity. This issue was properly preserved for appeal, and the Court of Appeals' decision should therefore be reversed.[55]

I. Under Kentucky law, sovereign immunity is strictly limited and does not extend to municipal corporations voluntarily created to perform localized proprietary services.

In *Comair*, this Court endeavored to bring order to Kentucky law concerning the scope of sovereign immunity. Recognizing that judicial attitudes about the propriety of immunity for certain governmental entities had "shifted back and forth over time," the

[55] *See* Motion for Discretionary Review; Appellant's Brief; R. 1820, 12/17/10 Order, attached as App. C; R. 1178-1220, Coppage Opp. to SD1 Mot. to Dismiss Third-Party Compl.

Court began with those points that are clearly established. *Comair*, 295 S.W.3d at 94. First, "pure sovereign immunity, ***for the state itself***, has long been the rule in Kentucky." *Id.* (emphasis added). Second, ***county governments***, "which predate the existence of the state and are considered direct political subdivisions of it," also enjoy immunity. *Id.* By contrast, it is equally clear under Kentucky law that "***[c]ities, as municipal corporations,*** ... while enjoying some immunity for much of this state's history, ***are now liable for negligent acts*** outside the legislative and judicial realms." *Id.* at 99 (emphasis added).

The Court's task in *Comair* was to define whether entities "fall[ing] outside this taxonomy of city versus state and county" are properly considered "agencies of the state, and therefore possibly entitled to immunity, or more akin to municipal corporations, and ... therefore liable in tort." *Id.* The inquiry thus focuses on the nature of the governmental entity at issue, and whether it is really an extension of the Commonwealth itself or a county government, or whether it is more properly classified as an ordinary non-immune municipal corporation. *Comair* instructed courts to focus on two factors: (1) the "origins of the entity" – *i.e.*, whether it was "created by the state or a county, or a city" – and (2) whether the entity performs a "function integral to state government," rather than "purely local, proprietary functions." *Id.* at 99-100. Both prongs must be satisfied for an entity to be endowed with sovereign immunity. "[B]oth of these inquiries – the sources of the entity in question and the nature of the function it carries out – are tied together to the extent that frequently only an arm of the state can exercise a truly integral governmental function (whereas municipal corporations tend to exercise proprietary functions addressing purely local concerns)." *Id.* at 100.

Comair emphasized the limited reach of sovereign immunity. As this Court

explained, sovereign immunity is a prerogative only of the Commonwealth itself and its "direct political subdivisions," and does not extend to cities or other "municipal corporations." *Comair*, 295 S.W.3d at 94-95. Sovereign immunity is "a common law concept that recognizes a quality (immunity from suit) of the sovereign state" that is enjoyed only by entities possessed of sovereignty, like counties, "which predate the existence of the state and are considered direct political subdivisions of it." *Id.* Thus, the limitations on sovereign immunity inhere in the concept of sovereignty itself. Sovereign immunity cannot be extended to an entity that is not itself sovereign. *See Ky. Center for the Arts v. Berns*, 801 S.W.2d 327, 329 (Ky. 1990).

Comair is therefore consistent with this Court's modern trend to narrowly construe the scope of sovereign immunity. "The concept that the government can do no wrong or that the government cannot afford to compensate those whom it wrongs in circumstances where a private entity would be required to pay is unacceptable in a just society." *Calvert* 805 S.W.2d at 138. Accordingly, "'sovereign immunity should be limited strictly to what the Constitution demands.'" *Id.* (quotation omittied). "Except for an occasional lapse, [this] Court has marched along this enlightened path." *Id.* The Court of Appeals decision represents a dramatic departure from this "enlightened path," and should be reversed.

II. SD1 is a municipal corporation with no sovereign immunity.

The Court of Appeals erred in holding that SD1 was entitled to sovereign immunity under the *Comair* test. In fact, SD1 satisfies neither prong of the *Comair* test. It does not perform a function "integral to state government," nor is it the alter ego or arm of any county government. SD1 is a special services district that provides utility services

in a limited area, and was created by consent and petition of those to be served, not by the exercise of the county or state's sovereign will. Thus, SD1 is not entitled to immunity from tort or contract claims.

A. SD1 does not perform a "function integral to state government."

The "more important" prong of *Comair's* sovereign immunity test "focus[es] on whether . . . the entity [exercises] a 'function integral to state government,'" or instead "exercise[s] proprietary functions addressing purely local concerns." *Comair*, 295 S.W3d at 98-99. This inquiry addresses ***both*** whether the function is "governmental," as opposed to proprietary, ***and*** whether it is a matter of "statewide," rather than local, concern. *See id.* at 99-100. Only entities that address "***state level*** governmental concerns," such as "police, public education, corrections, tax collection, and public highways," have a valid claim to immunity. *Id.* Thus, not every "public purpose" is an "integral state function" supporting the extension of sovereign immunity. Otherwise, every municipal entity at any level of local government could assert a claim to sovereign immunity, since all government agencies must confine their activities to valid "public purposes." *E.g., Dannheiser v. City of Henderson*, 4 S.W.3d 542 (Ky. 1999).[56]

Sanitary sewer districts do not perform functions "integral to state government" under this standard.[57] As this Court has recognized, sewer districts provide proprietary utility service to a local area, just like any privately owned utility company. Nor do SD1's obligations to comply with federal and state water pollution laws satisfy the

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[56] *Accord Bostic Packaging, Inc. v. City of Monroe*, 562 S.E.2d 75, 77 (N.C. App. 2002) (noting that whether acting as an "agency of the sovereign" or whether "acting within its proprietary powers," a public entity's actions "[i]n either event it must be for a public purpose or a public use," since even a "proprietary enterprise must, of necessity, at least incidentally promote or protect the general health, safety, security or general welfare....") (quotation omitted).

[57] This issue was preserved for review. R. 1178-1220, Coppage Opp. to SD1 Mot. to Dismiss (7/7/10) at 16-17; Appellant's Br. at 14-17.

"integral state function" test. SD1's obligations arise from the fact that SD1's operations are a potential source of harmful discharges into state waterways which are subject to regulation just like any private or other non-immune discharger, not because SD1 is performing a regulatory function on behalf of the state.

1. Established Kentucky precedent holds that sanitary sewer service is not a function integral to state government.

This Court's precedents squarely hold that sewer service is ***not*** a "function integral to state government." In *Calvert*, this Court held that the Louisville-Jefferson County Metro Sewer District was not entitled to sovereign immunity because it did not perform a "function integral to state government," 805 S.W.2d at 136, but rather "carr[ied] out a limited public purpose in a local area." *Id.* at 135. *Calvert* explicitly distinguished sewer districts from school districts and counties, noting that sewer districts "***classify as municipal corporations" and "perform[] services similar to a private corporation***...." *Id.* at 138 (emphasis added). Indeed, the plaintiff in *Calvert* was a privately-owned for-profit sewage treatment facility in direct competition with MSD, which alleged that MSD tortiously interfered with the plaintiff company's services contract with a city. *Id.* This Court explained that MSD, "when ***performing services similar to a private corporation***, should be liable for [its] torts." *Id.* (emphasis added). *Accord Transit Authority of River City, v. Bibelhauser*, No. 2011-CA-002039-MR, 2013 WL 5423061, at *3 (Sept. 27, 2013 ("TARC engages in a quintessentially local proprietary venture, i.e., providing transportation services, just like other for-profit taxi and bus services in the Louisville Metro area.").[58]

This Court's recognition that sewer service is a local proprietary function predates

[58] Unpublished decision, copy attached at App. D.

Calvert. In the *Gas Services* case, decided a decade before *Calvert*, this Court likened sewer utilities to natural gas utilities, and harshly criticized the "monstrosity" of the old municipal immunity doctrine for having "grown to such proportions that it provide[d] immunity for negligence in ***repair and maintenance of sewers***, a function previously ***regarded as one proprietary in nature*** and not protected...." *Gas Services Co., Inc. v. City of London*, 687 S.W.2d 144, 147-48 (Ky. 1985) (emphasis added). The Court believed that with its decision, the "judicially created monstrosity" had finally been "judicially destroyed." *Id. See also Louisville & Jefferson County Metro. Sewer Dist. v. Kirk*, 390 S.W.2d 182, 185 (Ky. 1965) (noting that sewer district's claim to immunity as "governmental functionary" was no longer tenable following abolition of municipal immunity). The Court of Appeals' decision in this case would revive that "monstrosity" once again.

Calvert and *Gas Services* were correct. Sewer services do not resemble any of the traditional "statewide" functions referenced in *Comair*, such as "police, public education, corrections, tax collection, and public highways." *Comair*, 295 S.W.3d at 99. Sewer service has never been considered a prerogative of the state. To the contrary, sanitation districts provide sewer services exclusively to residents of the district and collect rates from its customers for those services, just like any other local utility. *See* KRS 220.030; *Wessels Co. v. SD1 of N. Ky.*, 238 S.W.3d 673, 675 (Ky. App. 2007). *Accord Bostic Packaging, Inc. v. City of Monroe*, 562 S.E.2d 75, 829 (N.C. App. 2002) ("Because ... in setting rates for public enterprise services, municipalities act in a proprietary role, ... the operation of the defendant's sewer system, for which it charged rates, was a proprietary

function.") (quotation omitted).[59] SD1's installation of a new sanitary sewer line is no more a "function integral to state government" than a privately-owned water utility's (such as Lexington's Kentucky American Water) installation of a new water pipeline or an investor-owned electric utility's installation of a new power transmission line. [60]

Indeed, SD1 provides services that, in their absence, would be provided by incorporated municipalities, not counties. KRS 220.135 provides sanitation districts may take ownership of "the operational sewer and drainage system ***of each city*** located within the jurisdictional boundaries of the district." (emphasis added).

The Court of Appeals attempted – without avail – to distinguish this Court's decision in *Calvert* on the grounds that MSD was established pursuant to KRS Chapter 76, whereas SD1 was established pursuant to KRS Chapter 220. But MSD is organized under Chapter 76 rather than KRS Chapter 220 because it is a city-county sewer district in a county containing a first class city, KRS 76.010, not because it performs a fundamentally different function than SD1. MSD and SD1 are both public sewer utilities that operate the same types of facilities and perform the same services, except that the

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[59] Notably, the state sales tax statute, KRS 139.200 specifically lists "sewer services" alongside sales of "prepaid wireless calling service," hotel room rental, and consumer natural gas purchases, as ordinary "retail" sales subject to the state sales tax.

[60] Indeed, the Department of Local Government's KENTUCKY CITIES FINANCIAL MANUAL notes that differing accounting practices are required for "governmental funds" and "proprietary funds (business-type activities)," with the latter required to use "accrual basis" accounting, and explains "***[p]roprietary funds include the resources and operation of services that are similar to the commercial sector.*** For instance, ***water, gas and sewer utility funds are proprietary.***" KENTUCKY CITIES FINANCIAL MANUAL at 3 (available at http://kydlgweb.ky.gov/Documents/Cities/CitiesFinancialManualpdfonline.pdf) (emphasis added). Consistent with this direction, SD1's annual financial statement notes that it employs a "full accrual basis" in its financial statement, and that "[a]ll activities of SD1 are accounted for within a single proprietary (enterprise) reporting entity," which are typically used, among other things, for operations that are "financed and operated in a manner similar to private business enterprises where the intent of the governing body is that the cost (expense, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges...." SD1 ANNUAL REPORT, *supra* note 1, at 30-31.

scope of MSD's operations is significantly larger than SD1's.[61] Indeed, SD1 describes itself as the "second largest public sewer utility" in Kentucky, clearly inviting a comparison of its operations to MSD's.[62]

The Court of Appeals' reliance on SD1's authority over "storm water management" to distinguish it from MSD is also misplaced. (App. B, Opinion at 9 n.2.) First, the Court of Appeals is factually mistaken about MSD's enumerated powers, which expressly include "provid[ing] an effective and advantageous means for relieving the district area from inadequate sanitary ***and storm water drainage***...." KRS 76.080(2) (emphasis added). As a factual matter, MSD ***does*** manage a 376-square mile stormwater drainage system.[63] Second, operation of stormwater sewers is no more an integral state government function than operation of sanitary sewers. Like its sanitary sewer service, SD1 charges a proprietary fee for providing stormwater drainage services. *Wessels Co.*, 238 S.W.3d at 675. SD1 is a retailer of storm sewer services, and charges a fee and sales tax for storm sewer management services, just like its sanitary sewer service. Moreover, operation of storm sewers is a function traditionally performed by incorporated municipalities. Indeed, SD1 assumed operation of many of its storm water facilities from ***incorporated municipalities*** who had previously been operating the facilities themselves. *Id.* Recently, SD1 agreed as part of a settlement to ***return*** control over some of those storm sewer facilities – including responsibility for compliance with state and federal environmental permits – to one of those municipalities, the City of Cold Spring.[64]

The Court of Appeals' inability to identify any meaningful distinctions between

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[61] *See supra* notes 1-4, and accompanying text.
[62] http://www.sd1.org/AboutSD1/SD1_History.aspx.
[63] MSD Info. Brochure at pp. 4-5, http://www.msdlouky.org/aboutmsd/pdfs/MSD_gen_brochure_web.pdf.
[64] *Cold Spring Settles Storm Sewer Lawsuit*, CINCINNATI ENQUIRER, 2013 WL 15061275, June 20, 2013.

SD1 and MSD is evidenced by the fact that the Opinion based its ultimate holding on a conclusion which clearly contradicts *Calvert*, and would apply equally to MSD and SD1 – namely, that "[p]roviding and maintaining sewer facilities are functions of state-wide concern and are a necessary government function." (App. B, Opinion at 9.) The Court of Appeals did not engage in any contextual analysis of whether sewer facilities are traditionally handled at the state or municipal level, or whether such services could be characterized as proprietary. It simply announced, *ipse dixit*, that such function was of "statewide" importance, notwithstanding this Court's precedents to the contrary.

Nor is there any merit to the Circuit Court's belief that the holding of *Calvert* was somehow overturned by this Court's decision in *Comair*. To the contrary, *Comair* cited *Calvert* favorably, and acknowledged *Calvert* as a case that properly recognized the importance of the "essential state function" aspect of the test articulated in *Berns*. *See Comair*, 295 S.W.3d at 98. Consistent with *Calvert*, *Comair* premised its holding on the conclusion that the Airport Board "carries out a function ***integral to state government*** in that it exists solely to provide and maintain part of the Commonwealth's air transportation infrastructure." *Id.* at 101 (emphasis added). Indeed, control of airways and air traffic is obviously a matter of "statewide" concern. *Accord* KRS 183.121(1) ("The cabinet may designate … a state airways system which will serve the best interests of the state."). By contrast, sanitary sewer service has long been recognized by this Court as a "proprietary" and local function. *E.g.*, *Gas Services*, 687 S.W.2d at 147-48.

2. SD1's obligation to comply with federal and state environmental laws does not entitle it to sovereign immunity.

Equally unavailing are Appellees' arguments below that SD1's obligation to comply with federal and state environmental regulations means it performs a function

integral to state government. While enacting and enforcing environmental regulations may be a proper function of state government, SD1 is not an environmental regulator. SD1 is an entity that is ***subject to*** environmental regulations because its operations are a potential source of harmful discharges into state waterways. The legal duties imposed on SD1 pursuant to state and federal regulations are not duties that are unique to states or counties, but are imposed equally on various public and private entities that have no claim to immunity.

For example, Appellees below emphasized SD1's entry into a Consent Decree with the U.S. E.P.A. and the Kentucky Environmental and Public Protection Cabinet (the "Cabinet") as evidence of "both the state's control over SD1 and the fact that SD1 is performing a state governmental function." (DCI Ct. App. Brief at 12.) But this argument overlooks the fact that the Consent Decree was the result of a lawsuit filed by the EPA and the Cabinet ***against SD1***, asserting claims that SD1 committed "***violations of the CWA***, Kentucky's statutes implementing the CWA, and KPDES permits issued for the District's [waste water treatment plants]."[65] The Clean Water Act imposes technological compliance and permitting requirements on all kinds of entities – including purely private entities – who may be responsible for discharges into navigable waters, regardless of the entities' governmental or private affiliation. *See PUD No. 1 of Jefferson County v. Washington Dept. of Ecology*, 511 U.S. 700, 704 (1994); *Ky. Waterways Alliance v. Johnson*, 540 F.3d 466, 470 (6th Cir. 2008). The fact that a public or private entity is obligated to comply with water pollution limitations does not mean that entity is acting as a state agency.

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[65] *See* April 18, 2007 Consent Decree at p. 5, *Kentucky v. Sanitation Dist. No. 1 of N. Ky.*, No 05-199-WOB (E.D. Ky.) (available at http://www.epa.gov/compliance/resources/decrees/civil/cwa/covington-cd.pdf).

Appellees also point to KRS Chapter 224 and KAR Title 401 as evincing a statewide policy to protect the Commonwealth's public waterways and water supplies. But the fact that the state has an interest in protecting the water supply does not mean that every potential polluter who must safeguard against its own discharges is somehow performing a state function. Chapter 224 provides for regulation of environmental pollution by state government and a variety of multi-state commissions. Nothing in Chapter 224 delegates any regulatory authority to Chapter 220 sanitation districts.

Similarly, while 401 KAR 5:006 requires sanitation districts to prepare a Regional Facility Plan ("RFP") to satisfy the Clean Water Act's wastewater planning requirements, that provision applies equally to cities and municipal utility corporations created under KRS Chapter 96 which are not arms or agencies of counties or the state. *See* 401 KAR 5:006, § 3(1). Again, these obligations are imposed on SD1 by virtue of its obligation to comply with the state's regulation of environmental pollution, not as a delegation of state authority to regulate on the state's behalf. The fact that SD1 engages in activities that touch on, or are subject to, state environmental regulation does not confer sovereign immunity, nor does it change the fact that SD1 performs a quintessentially local and proprietary function – *i.e.,* providing sanitary sewer service to property owners in a local area on a fee-for-service basis.

Thus, SD1 does not perform any function "integral to state government." It provides utility services to customers for a fee and engages in activities traditionally performed by municipal and private corporations, not state or county governments. The fact that SD1 has obligations to ***comply*** with state and federal environmental regulations by virtue of the potential environmental impact of its activities (and litigation concerning

its own past violations of those laws) does not transform SD1 into an arm of the state. The expansive approach to the "state function" inquiry employed by the Court of Appeals would allow any valid "public" function (which is, essentially any function of government) to be characterized as a function "integral to state government." That approach would render the "state function" inquiry meaningless and expand the scope of sovereign immunity far beyond its constitutional and common law foundations.

B. SD1 is not the offspring or alter ego of an immune entity.

Analysis of SD1's "origins" or "parentage" also weighs heavily against extending sovereign immunity. SD1 was formed by voluntary petition of the municipalities to be served by it, not by the exercise of sovereign authority of the state or county governments. Pursuant to its governing statutes, moreover, SD1 is organized as a municipal corporation, governed by articles of incorporation and a board of directors. Indeed, "special districts" like SD1 are purposefully designed to be constitutionally independent of county governments, so as to avoid constitutional and statutory restraints on county debt and taxation limits. Thus, SD1's origins confirm that it is an independent municipal corporation, not an agency of any county government.[66]

The *Comair* opinion's "origin" inquiry focuses on whether the entity was brought into existence by the sovereign will of a sovereign entity, such as a county, or whether it is a ***consensually formed*** "municipal corporation," which has no immunity. *Comair*, 295 S.W.3d at 99 (emphasis added). The question is whether the defendant entity is itself possessed of sovereignty by virtue of its creation – *i.e.*, is it a direct "***agency (or alter***

[66] This issue was preserved for review. R.1178-1220, Coppage Opp. to SD1 Mot. to Dismiss (7/7/10) at 15-16; R. 1552-94, Coppage Resp. to SD1 Supp. Mem. (9/2/10) at 5-6; R. 1652-1705, Coppage Mem. in Opp. to DCI Supp. Mem. (9/23/10) at 5-6; Appellants Br. at pp. 17-21.

ego) of a clearly immune entity." *Id.* (emphasis added). Because sovereign immunity is an inherent attribute of the sovereignty of the Commonwealth itself, an entity that is not "born" sovereign cannot otherwise become possessed of the immunity that inheres in sovereignty. *Comair*, 295 S.W.3d at 94. *Accord Berns*, 801 S.W.2d at 329 ("[W]here no constitutionally protected sovereign immunity exists the General Assembly cannot by statute create it.").

As this Court explained in *Comair*, a key feature distinguishing non-immune municipal corporations from counties and other immune entities is whether the entity was created by voluntary consent or petition of the persons or municipalities to be served or, instead, was created by an act of sovereign will by the state or county itself. Municipal corporations are created by "***direct solicitation or by the free consent of the persons composing them,***" whereas sovereign entities are directly "***created by the ... state, of its own sovereign will, without the particular solicitation, consent, or concurrent action of the people who inhabit them:***"

> ***Municipal corporations proper are called into existence either at the direct solicitation or by the free consent of the persons composing them,*** for the promotion of their own local and private advantage and convenience. On the other hand: ***Counties.... are*** local subdivisions of the state, ***created by the sovereign power of the state, of its own sovereign will, without the particular solicitation, consent or concurrent action of the people who inhabit them.*** The former (municipal) organization is asked for, or at least assented to, by the people it embraces; the latter organization (counties) is ***superimposed by a sovereign and paramount authority.***

Comair, 295 S.W.3d at 100 (citation omitted) (emphasis added).

Applying this framework, SD1 is a consensually formed "municipal corporation." Under KRS 220.040, sanitation districts are formed by the filing of a "***petition***...containing valid signatures of sixty percent of those in possession claiming as

freeholders within the limits of the territory... or by the governing body of any municipality lying wholly or partly within the proposed district...." KRS 220.040(1)-(2). This petition requirement existed when SD1 was formed. 1940 Ky. Acts, Ch. 148, §4.

Accordingly, as this Court's predecessor acknowledged, SD1 "was created .... ***by petition*** of seventeen ***incorporated areas and communities***," to perform services for their benefit, which resulted in the "proper incorporation of the district ***as a separate municipal corporation***:"

> Sanitation District No. 1 of Campbell and Kenton Counties ... was created pursuant to Chapter 220 of Kentucky Revised Statutes ***by petition of about seventeen incorporated areas and communities*** located in northern Kentucky. Several of the larger cities, such as Newport and Covington, had existing sewer facilities and, in all, there were about 33,000 property owners who had connections with them. The big problem, however, was the collection and disposal of sewage. Separate undertakings to accomplish this end would have required a tremendous outlay of money and, therefore, as a community project, ***the several cities undertook, by the creation of this district, to accomplish by joint action at a lesser expense, the task of sewage disposal by modern methods***.

City of Covington v. Sanitation District No. 1 of Campbell & Kenton Counties, 301 S.W.2d 885, 886 (Ky. 1957) (emphasis added). SD1 was not "superimposed by a sovereign and paramount authority," but instead was "asked for, or at least assented to, by the people it embraces." *Comair*, 295 S.W.3d at 100.

SD1's status as an independent municipal corporation is further illustrated by its organization and management structure. KRS Chapter 220 expressly provides for the organization and governance of sanitation districts as municipal corporations, whose articles of incorporation are filed with the secretary of state, KRS 220.010-.50, and whose affairs and operations are "manage[d] and control[ed]" by a board of directors. KRS 220.140. *See also* KRS 220.270. Upon creation, a sanitation district "shall then be a

political subdivision...with the power to ***sue and be sued***, contract and be contracted with, incur liabilities and obligations...." KRS 220.110(1) (emphasis added). *Accord Caneyville Volunteer Fire Dept. v. Green's Motorcycle Storage, Inc.*, 286 S.W.3d 790, 803 (Ky. 2009) (holding "ability of the entity to sue and be sued in its own name" weighs against finding entity to be alter ego of the state).

The point is further illustrated by KRS 220.380(2), which expressly equates sanitation districts to "cities" for purposes of bond authority:

> The district may use the authority and procedures ***granted to incorporated municipalities*** by KRS 107.010 to 107.220 to accomplish its purposes pursuant to subsection (1) of this section. When applied to sanitation districts, terms used in KRS 107.110 to 107.220 shall be construed to mean the following: ***"city" means "district";*** "ordinance" means "resolution"; "clerk" means "secretary" or "secretary-treasurer"; "governing body" means "board of directors"; and ***"mayor" means "president of the board of directors."***....

(emphasis added).

Accordingly, prior Kentucky judicial decisions have recognized that "a ***sanitation district*** 'is a political subdivision, or ***municipal corporation'*** .... pursuant to KRS Chapter 220...." *Louisville/Jefferson County Metro Ethics Com'n v. Schardein*, 259 S.W.3d 510, 512 (Ky. App. 2008) (quotation omitted) (emphasis added). Similarly, in *Sanitation Dist. No. 1 of Shelby County v. Shelby County*, 964 S.W.2d 434 (Ky. App. 1998), the court held that county fiscal court oversight authority under Chapter 220 was sufficiently limited that county officials could not be considered to be exercising management authority over sanitation districts for purposes of KY. CONST. § 165. The court emphasized that county oversight provided in Chapter 220 is limited to "'determin[ing] whether a particular proposed project should be undertaken,'" whereas "'[o]nce the project has been approved, ***the district exercises sole authority in carrying it out. There***

is no question here of dual management....'" *Shelby County*, 964 S.W.2d at 437 (quoting *Curtis v. Louisville & Jefferson County Metro Sewer District,* 311 S.W.2d 378, 381 (Ky. 1958)) (emphasis added). The court concluded that allowing fiscal court oversight of sanitation districts was within the Legislature's "plenary powers in respect to the establishment and regulation of the government of ***municipalities***....." *Id.* at 437-38 (emphasis added).

Thus, while KRS Chapter 220 gives county governments certain powers to appoint directors and oversee certain activities of a sanitation district operating within their boundaries,[67] such appointment and oversight does not transform sanitation districts into county agencies. *See Kea-Ham Contracting, Inc. v. Floyd County Dev. Auth.*, 37 S.W.3d 703 (Ky. 2000) (holding entity was not entitled to same sovereign immunity as county government, emphasizing that "although the Authority's board members are appointed by the County Judge-Executive, they serve for a term of four years and have independent responsibility for making decisions for the Authority."). This limited oversight stands in sharp contrasted with LFUCG's control of the air board in *Comair*, 295 S.W.3d at 100-01, where this Court emphasized that under KRS 183.133(6), LFUCG was given the same general authority to prescribe rules and regulations as the board itself.

If the limited county appointment and oversight authority spelled out in KRS 220 were sufficient to make SD1 the "alter ego" of the county governments for the territories it serves, then all special services districts in Kentucky are "alter egos" of county government. Most "special districts" are subject to similar appointment of board members and oversight by the county governments for the territories they serve, but nonetheless – as with SD1 – "county government has little authority to regulate the day-

[67] *See* KRS 220.035, -.115, & -.140.

to-day operation of most special districts."[68] As the recent report of the Auditor of Public Accounts revealed, even this limited statutory oversight had in many cases become an overlooked formality, as many special districts have not complied with statutory requirements for fiscal court approval of district budgets, audit requirements, and other statutory oversight requirements.[69] Thus, the limited statutory oversight functions afforded to county fiscal courts cannot, by themselves, make Kentucky's myriad special districts "arms" or direct extensions of county governments.

Indeed, a primary purpose of the "special district" form of organization is its constitutional independence from county government, so as to avoid counties' constitutional and statutory debt and tax limits. *E.g.*, KY. CONST. § 157. "Special districts with taxing or bonding power have been a way to get around such limits, because they are ***independent of county government and their taxes and bonded indebtedness do not count as part of the county limit.***"[70] If special districts were truly merely arms of county governments, it would defeat this purpose. *See Lowery v. Jefferson County*, 458 S.W.2d 168, 173 (Ky. 1970) ("[I]t is plain that the ultimate power to decide whether the tax shall be levied cannot be vested in the governing body of a county or city, for then the purported district is in reality nothing but a subterfuge to evade limits on tax rates.").

Accordingly, while the State Auditor championed legislation designed to improve the transparency of special districts in response to the problems identified in the "Ghost Governments" report, he nonetheless successfully opposed amendments that would have given county fiscal courts veto or approval authority over special districts' taxing and rate decisions, because such control would make special districts' debt part of the county's

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[68] LRC, COUNTY GOVERNMENT IN KENTUCKY, *supra* note 7, at 128.
[69] *See supra* notes 41-45, and accompanying text.
[70] LRC, COUNTY GOVERNMENT IN KENTUCKY, *supra* note 7, at 127 (emphasis added).

overall debt and impair counties' borrowing and bonding ability.[71] Notably, the new legislation as enacted defines "special purpose governmental entity" – the newly coined nomenclature for special districts, which includes "sanitation, sewer, waste management, and solid waste services" districts – as an entity that, among other things, "[e]xercises ***less than statewide jurisdiction*** ... "[i]s governed by a board, commission, committee, authority, or corporation with policymaking authority that is ***separate from the state and the governing body of the city, county, or cities and counties[,] in which it operates***." KRS 65A.010(8) (emphasis added).

Thus, SD1 is not an agency of the Commonwealth or any county. It was called into existence by the petition of municipalities, not an exercise of a county's sovereign will. It does not draw from the state or county treasury. It is funded by rates charged for the services it performs and bonds issued against those revenues under the same statutes governing city bond issuances. Analysis of its origins and parentage do not, therefore, support its claim to sovereign immunity.

In sum, analysis of SD1's origins and organization demonstrate that it is a consensually formed municipal corporation, not the sovereign "offspring" of a state or county government. Analysis of SD1's "function" demonstrates that it provides proprietary utility services for a fee in a defined local area, just like any municipal or privately owned utility corporation. Thus, SD1 satisfies neither prong of *Comair's* sovereign immunity test, and the Court of Appeals decision should be reversed.

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[71] *Sarah Hogsed, State Auditor Voices Opposition to Amending Taxing District Oversight Bill*, RICHMOND REGISTER, 2013 WLNR 4451157, Feb. 20, 2013 ("Making fiscal courts directly responsible for the governance of special taxing districts would essentially double the size of county governments, the state auditor said. Also, any debt the special districts carry would become part of that county's overall debt, which could affect a fiscal court's ability to issue bonds for sewer, road and other infrastructure improvements."); *Jack Brammer, Lawmakers Pass Bill to Shed Light on Kentucky's Special Taxing Districts*, LEXINGTON HERALD-LEADER, 2013 WLNR 6156643, March 12, 2013.

C. The Court of Appeals erred in holding sanitation districts were entitled to immunity from contract claims to the same extent as the state government itself, and to a greater extent than county governments or indirect state agencies.

Because SD1 satisfies neither prong of the *Comair* test, it is not entitled to immunity from any claims, whether based on tort, contract, or statute. SD1 is subject to suit to the same extent as any ordinary municipal corporation or utility company. Nevertheless, even if *arguendo* SD1 were entitled to some form of immunity as an indirect state or county agency, the Court of Appeals nonetheless still erred in conflating the scope of that immunity – particularly for contractual claims – with the scope of immunity enjoyed by the Commonwealth itself, thus endowing SD1 with even broader immunity than county governments enjoy. Specifically, the Court of Appeals rejected Coppage's contract claims because they did not fall within the narrow confines of the ***state's*** statutory waiver of immunity in KRS 45A.245(1) for claims to enforce the express terms of written contracts to which the state is expressly a party. (App. B, Opinion at 11 (citing *Commonwealth v. Whitworth*, 74 S.W.3d 695, 699 (Ky. 2002))). But that statute does not define the scope of contractual liability for counties, or subsidiary agencies. Thus, at a minimum, the Court of Appeals should be reversed as to Coppage's contractual claims.[72]

Under Kentucky law, state government immunity from contracts is unique, and broader than that enjoyed by county governments. *See Illinois Cent. Gulf R. Co. v. Graves County Fiscal Court*, 676 S.W.2d 470 (Ky. App. 1984). In *Illinois Central*, the court recognized that ***counties'*** sovereign immunity does "not apply to suits seeking to

[72] This issue was preserved for review. R. 1178-1220, Coppage Opp. to SD1 Mot. to Dismiss (7/7/10) at 18; R. 1552-94, Coppage Resp. to SD1 Supp. Mem. (9/2/10) at pp. 3; R.1652-1705, Coppage Mem. in Opp. to DCI Supp. Mem. (9/23/10) at 8-9; Appellants Br. at 21-25.

compel administrative officers to satisfy a liability lawfully created by them." *Id.* at 471.[73] While the *Illinois Central* court recognized that this common-law limitation was abolished in suits against ***the state*** by *Foley Construction Co. v. Ward*, 375 S.W.2d 392 (Ky. 1963), it observed that "[t]he *Foley* decision made no mention of the application of sovereign immunity to lawful contracts made by counties" and cited with approval cases recognizing "the susceptibility of a county to suit on its lawful contracts." *Ill. Cent. Gulf R. Co.*, 676 S.W.2d at 472.[74]

Thus, counties' susceptibility to contract suit arises from an inherent limitation on the scope of immunity possessed by those entities, not the waiver contained in KRS 45A.245(1). Indeed, this Court in *George M. Eady Co. v. Jefferson County,* expressly held that KRS 45A.245 does not apply to suits against counties. 551 S.W.2d 571, 572 (Ky. 1977).

The scope of contractual immunity is even less certain here, moreover, because sanitary sewer districts are yet below the status of a county government, and could at best be entitled to immunity as in indirect agency of a county government. *Comair* did not address the scope of contractual immunity for such entities at all, confining itself to analyzing the airport board's liability in tort. And *Yanero v. Davis*, 65 S.W.3d 510, 526-

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[73] Similarly, in *Patrick v. Magoffin County Fiscal Court*, No. Civ. A. 99-270, 2000 WL 35800547, at *6 (E.D. Ky. July 27, 2000), a Kentucky federal district court held "sovereign immunity does not apply to actions based on lawful contracts made by a county judge pursuant to the resolution of a fiscal court." *Id.* at *6. Likewise, in *St. Matthews Fire Protection Dist. v. Aubrey*, 304 S.W.3d 56, 61 (Ky. App. 2009), this Court recognized that "as a general rule sovereign immunity does not defeat a valid contract claim" against a county.

[74] The *Illinois Central* court distinguished this Court's opinion in *George M. Eady Co. v. Jefferson County,* 551 S.W.2d 571, 572 (Ky. 1977), which held that sovereign immunity barred a claim for indirect consequential contract damages against a county alleging that the county's breach of an obligation to obtain rights of way caused damages in the plaintiff's performance of a construction contract, despite the presence of a "no damages" clause in the contract with the county. The *Illinois Central* court held this decision "was intended to apply only to the specific kind of claim involved there and not to an action such as this to recover the amount agreed by the parties to be paid upon the performance of a contract with a county." *Illinois Cent. Gulf R. Co.*, 676 S.W.2d at 472.

27 (Ky. 2001), distinguishing what it termed the "governmental immunity" afforded to indirect agencies of state and county governments and the absolute "sovereign immunity" afforded to state and county governments themselves, described "governmental immunity" as addressing whether an entity is "subject to tort liability." *Id.* at 527.

Thus, dismissal of Coppage's contract claims based on the application of KRS 45A.245(1) was error. SD1, even if an agency of a county, is not the state itself, so the scope of its contractual liability is not confined to the terms of the state's statutory waiver.[75] Even if SD1 were entitled to some immunity in tort, the Court of Appeals should be reversed insofar as it dismissed Coppage's contractual claims against SD1[76] on the basis of that statue.[77]

CONCLUSION

For the foregoing reasons, the Court of Appeals' decision should be **REVERSED** and the Kenton Circuit Court's summary judgment should be **VACATED**.

Counsel for Appellant, Coppage Construction Company, Inc.

[75] With the passage of the Kentucky Fairness in Construction Act, the General Assembly expressed a strong public policy preference to preserve 'damages for delay" claims by subcontractors to the broadest extent possible, including in situations where the contracting entity is a "public authority or government entity." See KRS 371.400(3) ("contracting entity" includes "public authority or other public entity"); KRS 371.405(2)(c) (preserving damages for delay rights).

[76] R. 957-1002, Coppage Third Am. Countercl. and Third Party Compl., Third Party Claim Counts I-IV, VII.

[77] Also, even assuming *arguendo* that SD1's contractual liability was limited to enforcement of express written contracts, Coppage has asserted claims arising from express written contracts – the SD1 Contract and the Coppage Contract. The fact that SD1's obligations to Coppage arise by virtue of SD1's assumption of the Coppage Contract under a novation, joint venture, or respondeat superior theory, or by virtue of Coppage's status as a third-party beneficiary, does not change the fact that the underlying contracts at issue are express written agreements, not implied or oral contracts.